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SUBJECT: Ukraine: Grain Export Quotas Lifted, but New Controls In Store

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11. (SBU) Summary: Citing crop damage from drought, the GOU appears poised to institute a new regime of export restrictions on Ukraine's grain market for the 2007/2008 market year. According to a June 4 decree, as well as the statements of GOU officials, the GOU will build up its reserves of wheat while limiting exports. The reserves are to be used to moderate bread price increases -- an important issue for voters in an election year. The GOU meanwhile published a resolution on June 8 allowing export of grain left over from the current market year. Grain traders expect that they will be able to export 300-400,000 tons before the market year ends on June 30. End Summary

Bread Prices in an Election Year

12. (U) Although recent rains have helped crops in northern and western Ukraine, crops have suffered significantly from drought in the oblasts of southern Ukraine. While agronomists all agree that the lack of precipitation has significantly affected probable yields, their estimates of the impact are not as severe as the GOU's. After the drought, the GOU reduced its projections of the wheat harvest from 19 down to 12.5 million tons. The consensus projection by Ukrainian agronomists on June 4 was for a harvest of 15.4 million tons though Cargill's estimate is slightly more pessimistic at 14.8 million tons. Although the government claims that there are ten drought-affected regions, Cargill sees crop yields as average or better in all oblasts but four: Odessa, Nikolayev, Zaporizhya, and Kherson.

13. (SBU) In a sign that the campaign for the September 30 election has begun, Prime Minister Yanukovich traveled On June 3 to drought-stricken agricultural lands near Odessa where he publicly pledged his government would help affected farmers and ensure that bread prices will not rise. According to a Cabinet of Ministers press release, the PM charged Economy Minister Kinakh with keeping bread prices in line. In like manner, President Yushchenko traveled on June 5 to Kherson, where he met with leaders of oblasts affected

by the drought, endorsing relief to farmers, but intimating that they should be allowed to sell grain at market prices. According to Cargill, Deputy Prime Minister Slauta and Minister of Agrarian Policy Melnyk have openly told the company that political concerns over bread prices were behind the GOU's intention to continue intervening in the grain market.

14. (SBU) First Deputy Prime Minister Mykola Azarov made clear to Ambassador in a June 4 meeting that the GOU would institute controls on grain exports for the 2007-2008 market year. Accompanied by Deputy Prime Minister for agrarian policy Victor Slauta, Azarov claimed that drought conditions in Ukraine's "bread basket" -- the south-central and south-eastern regions -- made the step necessary. He said the GOU would permit traders to honor already existing contracts for wheat and load ships already en route, but, he intoned gravely, that was "the maximum we can allow." Only a few days earlier, on May 31, Minister of Economy Kinakh had assured the visiting Staffdel Singh that grain export controls would not be re-introduced.

2006/2007 Wheat Export Quotas Finally Lifted

15. (SBU) Consistent with Azarov's statements, the GOU finally published on June 8 the Cabinet of Ministers resolution of May 16 lifting the wheat export quota. In expectation of that resolution's publications, traders already in May moved around 250,000 tons to the ports and contracted ships to prepare for export. Although the grain traders now are holding 960,000 tons of 2006 wheat, USDA estimates that they will only be able physically to get 300-400 thousand tons out of the country by before the end of the market year (June 30). (Comment: In meeting with Ambassador, Slauta feigned surprise that grain traders had not yet taken advantage of the May 16 resolution, though he was well aware that the resolution was still unpublished--and thus not in legal force--at that time. End Comment.)

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2007/2008 Plan: Export Limits and State Purchases

16. (U) The best indication of the GOU's current intentions toward the grain market came in a June 4 Cabinet of Ministers resolution on measures to address the drought currently affecting up to ten oblasts. While parts of the resolution discussed relief measures for drought-stricken farmers, it primarily comprised steps to prevent grain exports (presumably beginning July 1) and to increase government grain reserves. Key features of the resolution are instructions to agencies to:

- draft a resolution banning grain exports until the state can replenish national and regional grain reserves (MinEcon and MinAg);
- conclude forward contracts for 710,000 tons of milling wheat at recent average spot market prices (Agrarian Fund)
- conclude additional (amount unspecified) forward contracts for purchases of milling wheat, paying 50% in advance (State Material Reserve);
- find funding through amendments to the budget and other sources to finance grain purchases (MinEcon, MinFin, MinAg, and the State Material Reserve);
- recommend that local authorities establish 3-month supply grain stockpiles by August 17, 2007; and,
- consider adding corn and barley to the list of goods subject to price regulation (Note: wheat is already on the list).

17. (SBU) In meetings with grain producers and traders, GOU officials have been exploring ways of ensuring the government would be able to maintain a reserve without resorting to renewed export quotas. At the most recent meeting, on June 4, DPM Slauta and Minister of Agrarian Policy Melnyk called on industry to make its own proposals on how to meet the government's objectives. Slauta and Melnyk laid out three conditions for industry's plans: 1) that the state and millers be able to build up reserves in order to keep bread prices at "reasonable market prices"; 2) that the grain traders maintain their role as provider of liquidity to the

agricultural sector (by purchasing grain); and, 3) that the traders commit to not "over-exporting" wheat, by submitting crop estimates and a target for export quantities. (Comment: In the eyes of some grain traders, these three conditions were tantamount to the GOU telling them, "We want you to keep buying grain, but we want you to sell it to us at discount prices, and meanwhile, you can't sell much to world markets." End Comment.)

18. (SBU) The Ministers discussed with industry representatives in more detail the GOU's intent to use state reserves to keep bread prices low. Currently the Agrarian fund held 1 million tons of wheat, and the government was looking to acquire another 1.5 to 2 million tons, they told the agricultural industry reps. Having built up this reserve, the state would sell the grain at a discount to millers (and perhaps meat producers) to keep prices low. The GOU could also subsidize credits to the millers in order to finance grain purchases, they said. Newspaper reports also reveal that the GOU intends either through jawboning or through administrative measures, to limit markups charged for transportation, and profit levels at bakeries. (Note: Oblast governors already have authority to regulate prices and markups on three basic types of bread, produced by large bakeries. Most oblasts only limit the retail markup over wholesale prices, though some fix retail prices and/or explicitly limit profits of bakeries. End Note.)

Can Ukraine Build Reserves on the Cheap?

19. (SBU) It will not be easy for the GOU to finance such large purchases of grain. At current F.O.B. prices, even the 710,000 tons of wheat the GOU has officially decided to procure would cost \$149 million. Amendments to the Ukrainian budget passed on May 31 allocated \$20 million for grain purchases. The June 4 resolution envisions further budget amendments amounting to \$40 million, as well as an undetermined amount of funding from sales of inventories of the State Material Reserve. (Note: The State Material Reserve stockpiles a variety of materials for strategic or emergency use.)

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Grain traders are skeptical that farmers will willingly extend credit for forward grain sales to the government, which has shown a willingness to insist on delivery, while delaying repayment. In his meeting with the Ambassador, Azarov hinted that the state had enough leverage to ensure compliance from the farmers: he stated flatly that the GOU offered enough agricultural subsidies that he was sure grain prices would be acceptable. (Comment: Azarov is notorious for his fiscal hawkishness and his statist instincts. The policy described in the June 4 resolution is almost certainly his handiwork. End Comment.)

Isn't There a Better Way?

19. (SBU) Both the Ambassador in his meeting with Azarov, and the grain traders in their meetings with other GOU officials have suggested that the least disruptive way for the government to address the threat of rising bread prices would be to subsidize bread purchases by the needy. Cargill estimated that if wheat were sold at world prices in Ukraine, the cost to the government of subsidizing the difference in bread prices for needy consumers (60% of the population) would be approximately \$100 million/year. Cargill estimated the loss to farmers of restricting exports and maintaining a differential between Ukrainian and world wheat prices would be \$1 billion. Azarov responded to Ambassador that subsidizing bread consumption for a huge segment of the population (he estimated that 80% of Ukrainians would require assistance) was beyond the GOU's capacity. Slauta and Melnyk have likewise rejected proposals for bread price subsidies as too costly for the budget.

Comment: Is This the Whole Story?

110. (SBU) Building up state wheat reserves in order to provide cheap grain for basic bread production would not be the most market-disruptive option, if the GOU intended to buy at market prices and to allow unrestricted exports. Since it appears the GOU

will do neither of those things, the likely policy will disrupt trade and shift costs onto farmers and grain traders. The beneficiaries of this policy will be those who receive subsidized sale of state grain (millers and quite possibly meat producers) as well as the voters spared higher bread prices. Since this is Ukraine, the allocation of discount sales of state-owned grain provides an attractive opportunity for corruption. Likewise, any limitation on exports other than an outright ban could create opportunities for moneymaking among those charged with allocating export quotas or licenses.

Taylor